SMALL BUSINESS

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RESEARCH SUMMARY

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The Profitability of Small Business Lending by Small Banks

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Purpose

Small businesses rely heavily on commercial banks to meet their credit needs. In fact, a recent survey conducted by the Federal Reserve and the Office of Advocacy found that two-thirds of established small firms depend on banks for financing. Unfortunately, a commonly held view in the banking industry is that lending to small businesses means higher risk and lower profits. The skepticism is difficult to reject as little is known beyond the first-hand experiences of individual bankers about the effects of small business lending on bank profit and risk. Using newly available call report information, this study examines the relationship between small business lending activity and various dimensions of bank profit and risk for the years 1995 and 1996.

Methodology

Recognizing the importance of small business to the national economy, the Congress requires banks to include small business and small farm loan information in their call reports (Consolidated Reports of Condition and Income for U.S. Banks) filed with bank regulatory agencies). Although the size of the business borrower is not disclosed in call report data, the loan size is, and it is reasonable to assume that there is a close association between firm size and loan size. In this study, a small business loan is defined as a loan size of less than $250K, because this size category best captures credit supplies to small firms, while excluding most loans to large firms.

The call report data employed in the study cover all banks, but the researcher focuses on small banks—those with total assets of less than $100 million or in the range of $100 million to $500 million--because larger banks tend to have nominal exposure to small business loans as a percentage of total assets. Univariate and multivariate analyses are employed to examine the relationship between small business lending activity and various dimensions of bank profit and risk. Decile groupings are developed from the data for the entire banking population, which exceeds 9,000 banks. Thus, the deciles represent the small business lending activity of the banks relative to all U.S. insured banks, rather than with respect to small banks alone. Banks in decile 10 are in the top 10 percent of all banks for the respective ratio measure; banks in decile 1 are in the lowest 10 percent for the given category.

Highlights

- The univariate analysis revealed that small banks earn higher profit rates on small business loans than other assets on average. These higher average rates of return were found to be associated with increased bank risk, including credit, capital, liquidity, and funding risks.

- Holding constant various dimensions of bank risk and other bank characteristics, small business loans were still found to significantly increase bank profit under the multivariate analysis.

- Many small banks have little exposure to small business loans; for example, banks in deciles 1 to3 had no more than 6 percent of total assets allocated to such loans.

- On average, small banks tend to have small business loans-to-assets ratios of about 10 percent.

- About one in 10 small banks has a sizable exposure to small business loans; for example, banks in decile 10 had more than 25 percent of assets allocated to such loans.

- Within each bank size category, larger banks had higher return on assets (ROA) than smaller banks.

- Bank markets with higher concentrations of bank assets (or less competition) had higher ROAs than less concentrated markets.

- Higher loan loss, securities holdings, and purchased funds ratios reduced ROAs relative to other banks.

- Banks with higher capital ratios and off-balance sheet ratios had higher ROAs than other banks.

Summary and Conclusions

Analyses of recently available call report information strongly suggest that small business lending increases bank profits. Also, the data reveal that active small business lending banks follow distinctly different risk management practices relative to banks that do not make many small business loans. Even after holding constant various control measures of bank risk, asset size, and market competition, small business lending tends to boost bank profits. Thus, contrary to a commonly-held belief that such lending is risky and should be constrained, this study concludes that small business lending contributes positively to bank profits.

An important inference from the findings is that small-business-friendly banks have a higher tolerance for risk than other banks. Conservatively managed small banks shy away from small business loans. By contrast, more aggressive small banks with higher risk preferences commit more investment funds in small business loans. Thus, lender behavior is a key determinant of small business lending.

Ordering Information

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